

CalPERS Investment Beliefs Project

Board Working Session

April 15, 2013

Objectives

- Project Timeline
- Investment Beliefs Context
- Interview Themes and Staff Views
- Board Discussion
 - Respond to survey questions (clickers)
 - Discuss responses
 - Report out
- Next Steps

Project Timeline

27 interviews completed between 12/12/12 and 02/08/13:

- 12 Board
- 10 Investment Staff
- 3 Executives
- 2 External consultants

Interviews consisted of 90 minute discussions and required interviewees to respond to multiple questions on a rating scale as well as provide commentary to the statements. All responses were compiled and analyzed. The results lead to several themes for discussion.

March 18th Investment Committee (IC) – Stakeholder panel

March 22nd – Senior Investment Staff working session

April 4th – INVO Leaders meeting (IO 3+)

April 15th IC – Board working session

June 17th IC – Sustainability Workshop and Fiduciary Panel

July 15th Board Offsite – Recommendation of straw-man Beliefs to the Board for discussion

September 16th IC – Adoption of Investment Beliefs

What are Investment Beliefs?

Investment Beliefs are working assumptions about the investment world that underlie investment practices and decisions

- Provide a basis for strategic management of the investment portfolio
- Provide a framework for assessing new investment strategies and avoiding making changes on an ad-hoc basis
- Ensure alignment between Board and Staff
- Become part of culture – used for Board onboarding and Staff recruiting

Investment Beliefs Project – Second Phase

First phase

The first phase of the beliefs work was building foundations: understanding and classifying the primary elements of CalPERS staff and Board beliefs.

Second phase

In this second phase (which started with the Staff Working Sessions) the analysis is clustered within themes and aims to become more practical in application. In particular there is a focus on themes that have contentious and unsettled elements that require resolution. To probe these critical themes, the beliefs we are testing are clusters with embedded context, they are not singular points. This is consistent with the idea that a belief system is complex and will not have a linear structure.

We are using 'straw-man' belief statements as our method – these beliefs are test statements before moving to any final forms – most will be discarded, a few may survive. The beliefs we are testing include a number of normative statements that help to strengthen their application to CalPERS specific circumstances (CalPERS should do this, given this beliefs context...).

| Beliefs about beliefs | Process pointers |
|---|--|
| <ul style="list-style-type: none"> ▪ A beliefs process will surface sensitive issues and make people think | <p>Give the process time</p> |
| <ul style="list-style-type: none"> ▪ Guiding principles for the <u>beliefs process</u> <ul style="list-style-type: none"> ▪ The core beliefs belong to the Board as a unitary and unified body ▪ The staff provides guidance to the Board – strong influence on beliefs about investment content and strategy, but less influence on beliefs about core values and mission where Board views are paramount ▪ Questionnaires, interviews and group discussions are the key methods used in the process ▪ The beliefs process requires extreme sensitivity to the inevitable behavioral biases that occur in drafting and discussions –it is critical to work hard to preserve unbiased outcomes ▪ The process is best seen in three phases: 1. Foundations; 2. Resolutions; 3.Completion ▪ Ideally completion of Board core beliefs is followed by development of staff beliefs that nest within the Board beliefs | <p>Apply principles of engagement</p> <p>Staff require time to air their views and beliefs and provide guidance to Board</p> |

| Beliefs about beliefs, (con't) | Process pointers |
|--|--|
| <ul style="list-style-type: none"> ▪ Agreement on some beliefs (having the same view) will not be possible, but a settlement is possible in these cases (agree to work from same view) | <p>Work on a <u>settlement process</u></p> |
| <p>The tests of success of the beliefs selected are</p> <ul style="list-style-type: none"> ▪ Accuracy (correspondence of beliefs to the outcome) ▪ Alignment (strong agreement or settlement) ▪ Actionability of beliefs (decisions following from beliefs) | <p>Measure beliefs against this triple A framework</p> |

Interview Themes and Staff Views

Investment Beliefs Development: Interview Themes

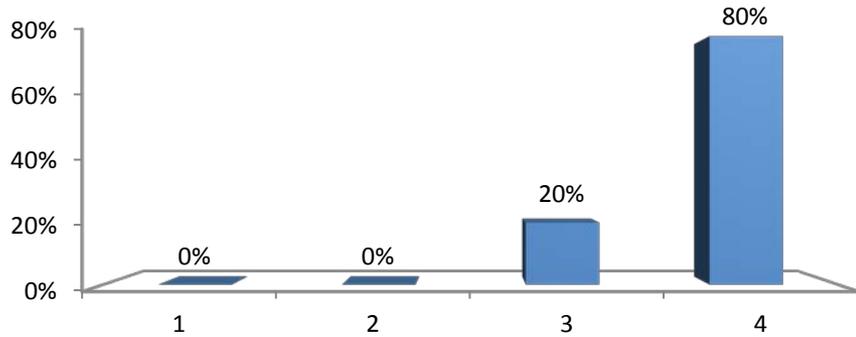
- Development of Investment Beliefs is an iterative process
- Start with broad concepts that become more granular to fully understand range of views
- Interviews with Board and Staff identified broad themes
 - Consensus themes
 - Contentious and unsettled themes
- Working session with Senior Investment Staff (Staff) explored contentious / unsettled themes in more detail
 - 85 detailed questions and sample portfolios
 - Discovered more consensus rather than less as questions became more granular
 - INVO Leaders meeting (IO 3+) to provide input on 3 specific questions
- Today
 - Working session for the IC to discuss contentious and unsettled themes
 - Present Staff views as input to the IC deliberations

Rating Key

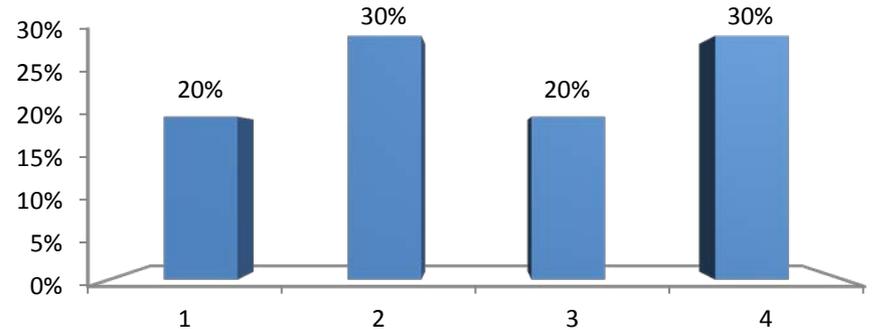
| Rating | Accuracy |
|--------|---|
| 1 | I don't believe this / believe this is usually wrong |
| 2 | I weakly believe this / believe this is sometimes right |
| 3 | I believe this / believe this is often right |
| 4 | I strongly believe this / believe this is almost always right |

Typical Range of Survey Responses

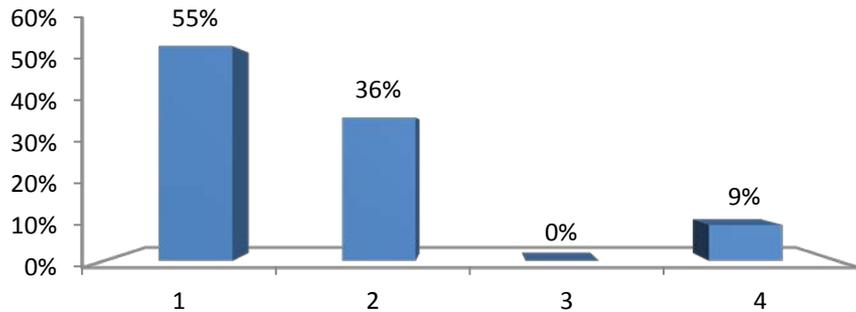
Strong Consensus*



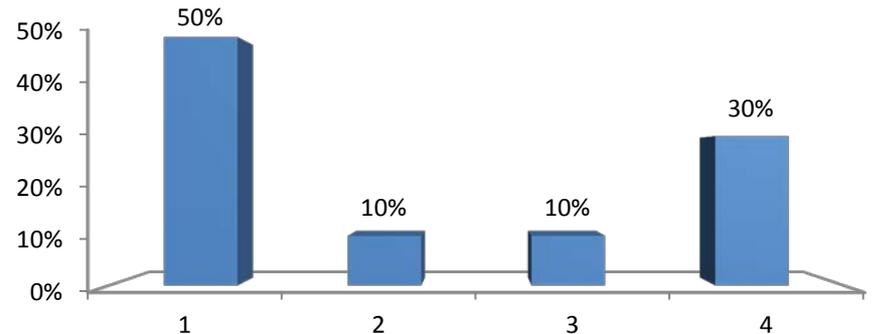
Mixed Views*



Low Conviction*



Strong Minority Views*



*Rating Key is provided on slide 10.

Interview Themes

Considering CalPERS through multiple perspectives does not lead to convergence on all themes, so a 'negotiated settlement' is going to be needed on some points. However, strong consensus across Board and Staff was found around the following themes:

1. Liabilities inform the asset structure
2. Strategic asset allocation (SAA) is the dominant determinant of return and risk
3. An expectation of return premium is required to take on risk
4. A long term investment horizon is an advantage
5. The market is not perfectly efficient, but inefficiencies are difficult to exploit after costs
6. An appropriate premium is required for illiquidity risk
7. Costs matter more than most investors think
8. Risk is often expressed as volatility or tracking error, but neither measure captures the essence of risk to CalPERS
9. CalPERS needs effective teamwork and governance

Interview Themes: Contentious and Unsettled Topics

- Active Management
- Private Asset Classes
- Sustainability (Environmental, Social and Governance) Factors
- Investment Performance Targets
- Stakeholder Considerations

Active Management: Asset Allocation

- Strong belief that CalPERS should aim to diversify its portfolio across broad, distinct risk factors / return drivers
 - 100 % believe or strongly believe this
- Strong belief that CalPERS should have a disciplined, clearly articulated process for rebalancing the fund to strategic targets
 - 82% believe or strongly believe this
- Support for the concept of adding value with more dynamic asset allocation but mixed views on CalPERS ability to do this
 - 50% either do not believe or weakly believe that CalPERS has the ability

Active Management: Public Markets

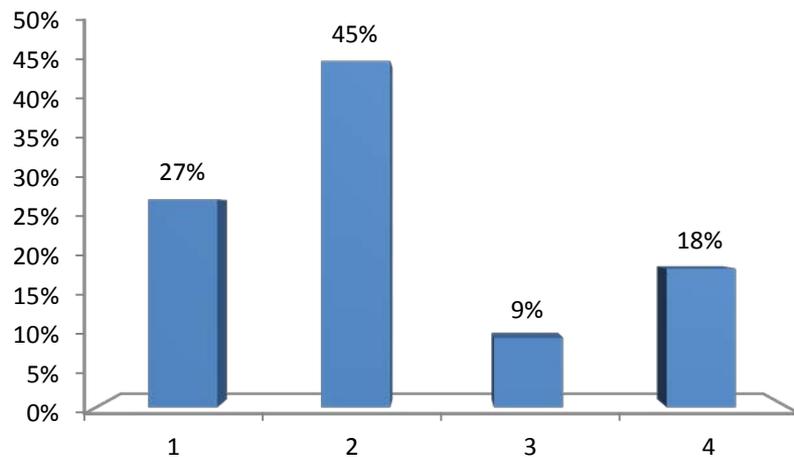
Very strong consensus that CalPERS should use index tracking mandates where the degree of market efficiency is greatest

- 100% of Staff either believe or strongly believe this (82% strongly believe it)
 - Low conviction about ability to add value by active management of public equity; market is relatively efficient
 - High conviction about ability to add value by active management of fixed income; market is less efficient
 - Majority of Staff believe that CalPERS could add value in equities by tracking non cap-weighted indices

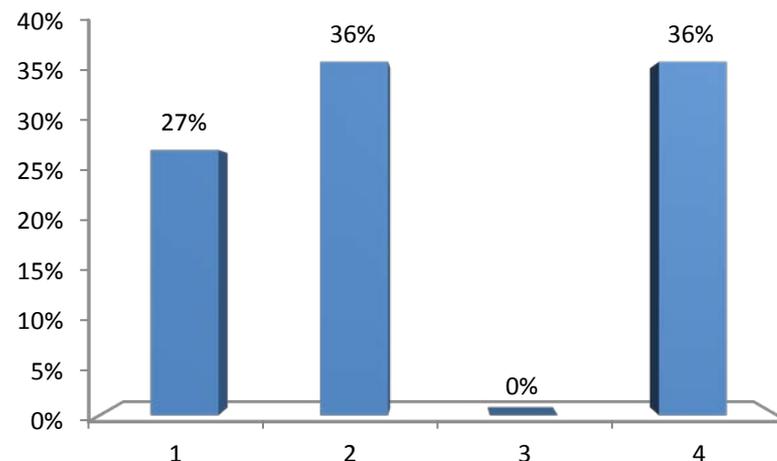
Active Management: Manager Selection and Alpha Generation

- In general, Staff is skeptical about CalPERS ability to select and monitor external managers who can deliver excess returns over time
- Skeptical about CalPERS ability to produce alpha after fees and costs over the long-term; although a minority strongly believe it is possible

Question: Given the skill, talent and resources CalPERS commands, it should be possible to produce alpha after fees and costs over the long-term*



Question: CalPERS alpha performance over the long-term is likely to be positive provided it is highly selective in the choice of strategies and managers used for active management*



*Rating Key is provided on slide 10.

Active Management: Hedge Funds

- Low conviction that hedge funds should be an important part of CalPERS strategy
- If used, stronger conviction that hedge funds should be used to reduce total fund volatility rather than deliver alpha
- Majority believe that future investments in hedge funds should be conditional on achieving considerable reductions in the fees and cost of investing
- Most Staff would allocate a small amount of the total fund (1%-2%) to hedge funds, and increase allocation if program delivers its return and volatility parameters
- Minority view that hedge funds are an important source of volatility reduction and warrant a relatively large (10%+) allocation

Private Asset Classes: Real Estate

Very strong conviction that Real Estate, especially Core Real Estate, should be an important part of CalPERS investment strategy –
91% strongly believe this

- Positive asset class attributes of operating cash flow and inflation hedging meet important needs of the fund
- Majority of Staff would increase the Real Estate allocation; none would reduce it
- Some believe that future investments should be conditional on achieving considerable reductions in fees and cost. However, this belief is much stronger for Private Equity and Hedge Funds than for Real Estate, reflecting Real Estate's alignment of interests work
 - 55% strongly believe this for Private Equity
 - 45% strongly believe this for Hedge Funds
 - 18% strongly believe this for Real Estate

Private Asset Classes: Private Equity

Staff believe that Private Equity should be an important part of CalPERS strategy, but there is less conviction about Private Equity than Real Estate

- Private Equity's potential to outperform Public Equity is an important source of return for the fund
- Mixed views on whether the returns in Private Equity are sufficient to compensate for the illiquidity and complexity of these assets
- Strong belief that CalPERS future investments in Private Equity should be conditional on achieving considerable reductions in the fees and cost of investing (82% believe or strongly believe this)
- Majority of Staff would reduce the current Private Equity allocation due to concerns about diluting returns at such large size; however, they would continue to invest significant amounts in the asset class (e.g., reduce allocation from 14% to 7-10%)

Private Asset Classes: Infrastructure

- Staff support the concept of investing in Infrastructure
 - Potential to generate operating cash flows and hedge inflation are attractive characteristics
- Significant concerns about the ability to execute at the scale needed to meaningfully impact the total fund
 - Difficult transactions to close with very long timelines
 - Complex structures make governance difficult
 - More attractive tax exempt financing is available for many needs
- Only 36% believe or strongly believe that the fund's Infrastructure allocation should be increased

Sustainability (Environmental, Social and Governance) Factors

Staff believe that strong Corporate Governance adds value and that CalPERS should engage companies on governance issues. Weaker consensus on environmental and social factors; awaiting research initiative results

| Belief | Believe or Strongly Believe This |
|--|----------------------------------|
| Long-term value creation requires companies to successfully managed 3 forms of capital: financial, physical and human | 100% |
| Companies with strong corporate governance outperform over the long-term and manage risk effectively | 91% |
| Effective management of environmental and social factors improves company performance over the long-term | 72% |
| Staff beliefs regarding engagement and incorporation of sustainability factors into investment decision making: | |
| <ul style="list-style-type: none"> CalPERS should engage companies on governance issues | 90% |
| <ul style="list-style-type: none"> Environmental factors should be incorporated into decision making by investors | 81% |
| <ul style="list-style-type: none"> Social factors, in particular a company's human capital practices including fair labor practices, health and safety, responsible contracting and diversity, should be incorporated into decision making by investors | 72% |
| <ul style="list-style-type: none"> CalPERS should engage companies on environmental and social issues | 63% |

Sustainability (Environmental, Social and Governance) Factors

- Strong consensus that CalPERS should play a role in promoting fair, orderly and effectively regulated capital markets (100% believe or strongly believe this)
- Staff does not believe that CalPERS should play a role in promoting macro-economic growth
 - Unclear what role CalPERS could play that would be effective
- Staff does not believe in targeting investments at specific social goals such as job creation, economic growth in California, or environmental strategies
 - Weak performance of such programs in the past

Additional Staff Beliefs

Investment Performance Targets

Long-term success measures should include delivery of target rate of return and improving funding status

Long-term returns relative to an appropriate benchmark should be used when evaluating external managers and staff

Mixed views on whether it is possible to design incentives / performance fees that align interests of fund and staff or fund and external managers

Internal Governance and Capabilities

Public entity status creates considerable constraints (e.g., compensation, civil service, contracting) that should be considered when choosing strategic asset allocation and investment strategies

In general, Staff believe that the investment program should be simplified; although, there are differing views on how to accomplish this

Stakeholder Considerations

Mixed views on whether CalPERS can consider broader stakeholder views or factors other than financial risk and return in its actions

Investment Beliefs Implications: INVO Leader (IO 3+) Working Session

- “Deep Dive” discussion around 3 potential beliefs:
 - We believe long-time horizon is an advantage. How can we structure the CalPERS portfolio to take advantage of our long-time horizon?
 - How can CalPERS add value in active management in public markets?
 - How can we structure fee agreements to align interests between the fund and external managers / fund consultants?

Investment Beliefs Implications: Senior Staff Sample Portfolios

Two world views:

- Because CalPERS is underfunded, we should *maintain or increase* equity / growth risk in the portfolio
- Because CalPERS is underfunded, we should *decrease* equity / growth risk in the portfolio

Today's Investment Committee Discussion

- Investment Staff Q & A
- Investment Committee Voting
 - 60 questions
- Table discussion focusing on areas with mixed views or lack of consensus
 - Important to understand minority view
- Report Out

Next Steps

- Develop straw-man beliefs based on today's results
- June 17th IC – Sustainability Workshop and Fiduciary Panel
- July 15th Board Offsite – Recommendation of straw-man Beliefs to the Board for discussion
- September 16th IC – Adoption of Investment Beliefs